

# City of Detroit

## CITY COUNCIL

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**ANNE MARIE LANGAN**  
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**TO:** COUNCIL MEMBERS

**FROM:** Irvin Corley, Jr., Director *ICJ*

**DATE:** January 6, 2010

**RE:** Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements as of June 30, 2008 Performed in Accordance with Government Auditing Standards

Line item 7 on today's Budget, Finance and Audit committee calendar represents the receipt of the Comprehensive Annual Financial Report (CAFR) for the fiscal year ending June 30, 2008.

Usually, along with the CAFR, Council also receives the independent auditor's (KPMG LLP's) report on Internal Control over Financial Reporting and on Compliance and Other Matters (ICOFRCOM) based on the respective CAFR audit. As of yet, your Honorable Body had not received this report, so I am providing you a copy, which is attached.

In the ICOFRCOM, the external auditor (KPMG) points out where there are significant internal control deficiencies, reportable conditions of noncompliance, or other relevant matters as a result of the audit of the 2008 CAFR. Specifically, KPMG cited significant internal control deficiencies in the following areas:

- Financial Closing and Reporting
- Authorization, Approval, and Segregation of Duties
- Reconciliations, Transaction Processing, and Document Retention
- Information Technology
- Arbitrage
- Filing of Financial Statements
- Escheatment Law
- Bond Ordinances

All comments appeared in the ICOFRCOM based on the 2007 CAFR, except the comments on "bond ordinances", which is new.

On the surface, this appears that the Administration needs to seriously focus on addressing these internal control issues to help circumvent financial reporting and other operational problems in the future.

Whenever your Honorable Body sets a discussion on the 2008 CAFR, that discussion should include this ICOFRCOM as well.

**Attachment**

cc: Council Divisions  
Auditor General's Office  
Norman White, CFO/Group Executive  
Pamela Scales, Budget Director  
Kamau Marable, Mayor's Office



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**Independent Auditors' Report on Internal Control over  
Financial Reporting and on Compliance and Other Matters  
Based on an Audit of Financial Statements Performed in  
Accordance with *Government Auditing Standards***

The Honorable Mayor Dave Bing  
and  
The Honorable Members of the City Council  
City of Detroit, Michigan:

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Detroit, Michigan (the City), as of and for the year ended June 30, 2008, which collectively comprise the City's basic financial statements and have issued our report thereon dated November 20, 2009. Our report was modified to include a reference to other auditors and to emphasize the City has an accumulated unreserved undesignated deficit in the General Fund of \$219 million as of June 30, 2008 which has contributed to the City's dependence on short-term borrowing for cash flow purposes. Our report also emphasized the City adopted the provisions of Governmental Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting by Employers for Post Employment Benefits Other Than Pensions*, during the year ended June 30, 2008 and the City ceased reporting regulatory assets and liabilities under Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation*, as of July 1, 2007. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Other auditors audited the financial statements of Detroit Brownfield Redevelopment Authority, Detroit Public Library, Detroit Transportation Corporation, Downtown Development Authority, Eastern Market Corporation, Economic Development Corporation, Greater Detroit Resource Recovery Authority, Local Development Finance Authority, Museum of African American History, the General Retirement System and the Policemen and Firemen Retirement System, as described in our report on the City's basic financial statements. This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors. The financial statements of Detroit Brownfield Redevelopment Authority, Detroit Public Library, Downtown Development Authority, Eastern Market Corporation, Greater Detroit Resource Recovery Authority, Local Development Finance Authority, Museum of African American History, General Retirement System, and Policemen and Firemen Retirement System were not audited in accordance with *Government Auditing Standards*.

**Internal Control over Financial Reporting**

In planning and performing our audit, we considered the City's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal



control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the City's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies and material weaknesses.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control over financial reporting. We consider the deficiencies described in the accompanying schedule of findings and responses as findings 2008-1, 2008-2, 2008-3, and 2008-4 to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. We believe the significant deficiencies described above are material weaknesses.

#### **Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the City's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings and responses as findings 2008-5, 2008-6, 2008-7, and 2008-8.

The City's responses to the findings identified in our audit are described in the accompanying schedule of findings and responses. We did not audit the City's responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the Mayor, City Council, City management, federal awarding and pass-through agencies, and the Treasurer of the State of Michigan and is not intended to be and should not be used by anyone other than these specified parties.

**KPMG LLP**

Detroit, Michigan  
November 20, 2009



## **CITY OF DETROIT, MICHIGAN**

### **Schedule of Findings and Responses**

Year ended June 30, 2008

#### **Finding 2008-01 – Financial Closing and Reporting**

Deficiencies exist in the processes to evaluate accounts, record entries into the general ledger, and prepare financial statements. These deficiencies include the following:

- The process to close the books and prepare closing entries and financial statements relies partly upon decentralized accounting staff and software applications other than the City's DRMS general ledger. The process requires a significant amount of manual intervention.
- The process to identify significant transactions throughout the City's fiscal year to determine the appropriate accounting treatment does not result in timely consideration as to how to record or report such transactions. These transactions often are not identified until the end of the fiscal year during the financial reporting process. There is inadequate communication between various City departments on transactions and on how they affect the individual stand-alone financial reports and the Comprehensive Annual Financial Report (CAFR).
- The process to close the books and prepare financial statements includes the recording of a significant number of manual post-closing entries.
- The process to close the books and evaluate accounts occurs only on an annual basis instead of monthly or quarterly. As a result, certain key account reconciliations and account evaluations are not performed timely and require an extended amount of time to complete during the year-end closing process. Information necessary to effectuate a timely and accurate closing of the books is sometimes not communicated between certain departments and agencies of the City.
- The process to close the books and prepare closing entries and financial statements does not utilize enough adequately trained and appropriately experienced employees to prepare the financial statements or monitor reporting issues throughout the year. There is inadequate supervisory review and approval of accounting transactions.
- The established internal control procedures for tracking and recording capital asset activities are not consistently followed. Physical inventories of capital assets are not being performed annually as required by City policy.
- The process for establishing legal case reserves and tracking the status of cases is predominantly manual in nature and very time-consuming. The volume of open litigation along with the frequency in status changes for the cases increases the difficulty in maintaining an updated case reserve listing without significant manual intervention.
- The process to determine the proper classification of grant revenues did not originally include an appropriate determination of whether the grant was from a State or Federal source.

#### ***Recommendation***

We recommend management continue to develop and refine its financial reporting systems and processes. Refinements should include assignment of accounts and reporting units to qualified personnel to conduct detailed analysis of accounts throughout the year and financial reporting process. We further recommend management conduct a thorough assessment of the adequacy and completeness of the City's accounting and financial reporting policies and procedures. Based on the results of the assessment, determine the need to develop new policies and procedures and/or reinforce the existing policies and procedures to personnel. We also recommend



## **CITY OF DETROIT, MICHIGAN**

### **Schedule of Findings and Responses**

**Year ended June 30, 2008**

management evaluate the City's organizational structure and personnel composition to determine the adequacy of the accounting related skills and knowledge of assigned personnel in relation to their assigned duties.

#### ***Views of Responsible Officials***

We have reviewed the finding and concur with the recommendation. However, due to turnover and lack of trained and developed accounting staff the recommendation for this finding and the other findings will take some time to fully implement. Layoffs and turnover in accounting and management staff and lack of training and staff development over the past several years has contributed to the City's accounting and financial reporting problems.

The City is presently rebuilding the accounting division and making improvements to the accounting and financial reporting systems. The City will continue to add qualified staff and make improvements including adopting the recommendations herein. New accounting tools, such as "GL Wand", have been obtained that will facilitate the timely completion of financial reports in the future.



## **CITY OF DETROIT, MICHIGAN**

### **Schedule of Findings and Responses**

Year ended June 30, 2008

#### **Finding 2008-02 – Authorization, Approval, and Segregation of Duties**

Internal control policies and procedures are intended to be designed to mitigate risks to the City. Control activities that don't operate as intended represent failed control activities and increase risks to the City. Deficiencies exist in the areas of authorization, approval and segregation of duties. These deficiencies include the following:

- Appropriate approvals and segregation of duties did not exist for a significant number of journal entries during the year. Journal entries lacked supervisory approval and in some cases were prepared, posted, and approved by the same individual.
- Appropriate authorizations and approvals did not exist for certain purchase orders selected for testing.
- Authorization to open, close, or change bank accounts is not properly followed.
- Approvals on employee timesheets did not exist for a number of timesheets.
- An appropriate segregation of duties does not exist for the Gas and Weight Tax revenue collections as the same individual opens the mail, logs the checks, and prepares the journal entry to record the receipt.
- Approvals indicating supervisory review of reconciliations and analyses are not consistently performed or documented.
- Timely supervisory approval of bank reconciliations did not exist for certain accounts.

#### ***Recommendation***

We recommend management conduct a knowledge and competencies assessment of supervisory personnel to ensure supervisory level accounting and finance personnel are knowledgeable in internal control activities and the financial closing policies of the City. We further recommend management implement new procedures to monitor internal control activities to determine if policies are being adhered to throughout the year.

#### ***Views of Responsible Officials***

We have reviewed the finding and concur with the recommendation. Improvements have been made in the past year (Fiscal year 2008-09), in properly segregating duties and approving journal entries. The City has contracted with a local accounting firm to provide training to City supervisory accounting personnel. The Finance Department will work toward creating training programs and developing competent accounting supervisors. Also, the Department will implement new procedures to monitor internal control activities.



## **CITY OF DETROIT, MICHIGAN**

### **Schedule of Findings and Responses**

Year ended June 30, 2008

#### **Finding 2008-03 – Reconciliations, Transaction Processing, and Document Retention**

Operations of the City are carried out by numerous City departments utilizing a variety of people, processes, and systems. This type of environment requires diligence in ensuring accurate information is processed and shared. Performing reconciliations of data reported from different systems is an integral part of ensuring transactional data integrity and accurate financial reporting. Deficiencies exist in the areas of transaction processing, data integrity, reconciliation performance, and document retention. Those deficiencies include the following:

- Data provided to the actuaries that assist in estimating workers' compensation liabilities is not tested for accuracy and reconciled to supporting data.
- A comprehensive listing of covenants and terms related to financing arrangements is not maintained and reconciled to original supporting documents.
- A listing of internal controls employed by service organizations is not prepared and evaluated for adequacy. Various service organizations process transactions for the City on a contractual basis.
- Bank, investment, imprest, and petty cash reconciliations are not prepared timely, and reconciling differences are not fully investigated and resolved in a timely manner.
- Data in the human resources system did not match data in the employee personnel files.
- Cash collections and accounts receivable data which is processed by third party service providers is not reviewed and tested for accuracy.
- Income tax returns are not reconciled to available data regarding State and Federal filers to identify nonfilers of City of Detroit returns.
- Cash collections are not recorded timely on a consistent basis.
- Historical data for Water and Sewer accounts receivable was not maintained as the files were inadvertently over-written.
- Capital projects that are complete are not closed out and placed into service categories on a timely basis.
- Additions to Capital projects are not adequately reviewed to ensure that additions are capital in nature. As a result, certain operating expenses were incorrectly recorded as capital assets.
- Interfund and inter-departmental transactions are not reconciled throughout the year on a timely basis.
- A significant number of bank reconciling items are over one year old and have not been investigated and resolved.

#### ***Recommendation***

We recommend management develop reconciliation policies and procedures which include thresholds based on the type and purpose of the reconciliation to ensure reconciling differences are appropriately identified and researched. The policies should require reconciling items are cleared within 30 days of identification and documentation is prepared to support and explain the reconciling differences and the related resolution.





**CITY OF DETROIT, MICHIGAN**

**Schedule of Findings and Responses**

**Year ended June 30, 2008**

***Views of Responsible Officials***

We have reviewed the finding and concur with the recommendation. As discussed previously, the Finance Department will implement training and development programs to improve accounting staff. The Department has improved its financial analysis, which will enable accounting staff to focus on variances to identify errors and problems. During the audit the accounting staff did better reviews and reconciliations, which provided the auditors with more reliable data than in past audits. In addition, the Department will develop reconciliation policies and procedures to ensure reconciling differences are identified and researched in a timely manner.



## **CITY OF DETROIT, MICHIGAN**

### **Schedule of Findings and Responses**

Year ended June 30, 2008

#### **Finding 2008-04 – Information Technology**

General controls and application controls work together to ensure the completeness, accuracy, and validity of financial and other information in the systems. Deficiencies exist in the areas of general and application controls. Those deficiencies include the following:

- Access to powerful administrator ID's is shared by multiple employees.
- ID's for terminated employees remained active after termination.
- Periodic reviews of user access are not performed.
- Password parameters are inadequate.
- Documents supporting adding, deleting, or modifying user access were not retained.
- Adequate procedures are not in place to log and approve configuration changes for certain applications.
- Program developers have access to move program changes into production for certain applications.
- Vendors supporting certain applications can make program changes without approvals.
- Certain tickets related to problems and incidents were not resolved in a timely manner.

#### ***Recommendation***

We recommend the following:

- Develop and enforce stronger password parameters such as password length of at least 6 characters, password expiration every 90-120 days, enforce alpha-numeric password and suspend ids after 5 invalid login attempts.
- Create and enforce a policy that requires each user to have a unique id, change the passwords to the default system ids, restrict access to default and administrative ID's, minimize the use of generic ids, turn audit on to log activity.
- Create controls and procedures to suspend or disable separated employees, implement scripts to suspend ids not used for 45-60 days, implement programs to generate reports showing ids inactive for longer than 45-60 days and subsequently manually suspend those ids.
- Create and enforce a policy that requires review of user access on a periodic basis, correct user access based on review results and maintain before and after logs to review results.
- Create a matrix to identify application functions that when granted together will give rise to segregation of duties conflict. Follow and enforce the segregation of duties matrix to ensure that segregation of duties conflicts do not exist at the time of role/profile creation.
- Create and enforce a policy to log all confirmation changes, obtain approval from authorized individuals for all configuration changes and perform appropriate testing on all confirmation changes prior to promoting changes to production.
- Develop and enforce a policy that does not grant access to developers to promote changes into production and access to promote changes into production should be restricted to authorized individuals.



**CITY OF DETROIT, MICHIGAN**

**Schedule of Findings and Responses**

**Year ended June 30, 2008**

- Implement and enforce adequate procedures to log and track problems and incidents.

***Views of Responsible Officials***

We have reviewed the finding and concur with the recommendation. Finance Department staff are presently working with Information Technology staff on implementing the Information Technology recommendations.

In the current year the City has changed the password parameters and controls for key financial systems. In addition, the City has identified systems that are in the process of being retired, for which parameters will not be changed. The City will continue to work toward improving information technology controls.



## **CITY OF DETROIT, MICHIGAN**

### **Schedule of Findings and Responses**

**Year ended June 30, 2008**

#### **Finding 2008-05 – Arbitrage**

The City has not implemented the necessary procedures to ensure compliance with the arbitrage rebate rules of Section 148(f) of the Internal Revenue Code of 1986 applicable to the City's outstanding tax exempt obligations. In discussing this with City officials, they stated the lack of written City policies and procedures regarding the monitoring and calculating of arbitrage rebates caused the City to fail to comply with the rebate rules.

Internal Revenue Code § 148(f) requires certain earnings on nonpurpose investments allocable to the gross proceeds of a bond issue be paid to the United States to prevent the bonds in the issue from being arbitrage bonds. Section 148 of the Internal Revenue Code requires compliance with the rules be ascertained by conducting a series of steps to calculate the amount to be rebated.

Nonpayment of rebates when due could result in the loss of tax-exemption for interest on the bonds or in the payment of penalty and interest.

#### ***Recommendation***

We recommend Management conduct all necessary activities to calculate rebates, submit filings, and pay rebates and/or penalties and interest owed. We further recommend Management develop and implement new written policies and procedures to ensure compliance is maintained on a go-forward basis.

#### ***Views of Responsible Officials***

We have reviewed the finding and concur with the recommendation. The City has a new Treasury Cash Management System that will facilitate compliance with the Arbitrage Rules. Also, the City's Treasury Department has added a new cash manager that will be responsible for compliance with the Arbitrage Rules. Finance personnel are currently working with City attorneys to develop and implement procedures to ensure compliance with the Arbitrage Rules.



## **CITY OF DETROIT, MICHIGAN**

### **Schedule of Findings and Responses**

**Year ended June 30, 2008**

#### **Finding 2008-06 – Filing of Financial Statements**

The City did not file audited financial statements by the required deadline. The City submitted the June 30, 2008 financial statements on November 20, 2009 and has not yet submitted the June 30, 2009 financial statements. In discussing this with City officials, the stated changes in personnel along with increasingly complex transactions and reporting standards have made it difficult for the City to modify its closing procedures to accommodate the changing conditions

Michigan Compiled Laws Section 141.424 requires each local unit file the annual financial report with the State Treasurer within 6 months of the local unit's year end.

The Treasurer has the authority when audited financials are not submitted within the six-month period to withhold the local government's State Revenue Sharing distribution. Accordingly, the Treasurer has withheld \$23.0 million revenue sharing associated with the fiscal year ended June 30, 2008. The Secretary of State has the authority to suspend the City's certificate of motor vehicle self-insurance when required financials, with application are not submitted 30 days prior before the desired effective date of the certificate. Failure to adhere to the requirement may result in the cancellation of the certificate of motor vehicle self-insurance. However, the Secretary of State has continued to extend the City's certificate of motor vehicle self-insurance, on a month-to-month basis contingent on the City continuing ability to meet plans to correct these deficiencies.

#### ***Recommendation***

We recommend Management develops a comprehensive plan to effectuate a timely closing of the books and preparation of financial statements.

#### ***Views of Responsible Officials***

We have reviewed the finding and concur with the recommendation. The Finance Department added new contractual staff and new accounting staff in 2008 and 2009 to more timely complete the June 30, 2007 and June 30, 2008 audits. Improvements have been made and are expected to continue. However, the department does not anticipate meeting the required deadline until December 31, 2010 when it expects to have the June 30, 2010 annual financial report filed on time.

The Department has year-end closing procedures and has tools such as the PBC (Prepared By Client) list with staff assignments and due dates, which will enable the City to file timely financial statements. The Department will prepare a comprehensive plan to complete and file the June 30, 2009 annual financial report by June 30, 2010 and the June 30, 2010 annual financial report by December 31, 2010.



## **CITY OF DETROIT, MICHIGAN**

### **Schedule of Findings and Responses**

Year ended June 30, 2008

#### **Finding 2008-07 – Escheatment Law**

The City has not filed the required annual report of unclaimed property to the State of Michigan. Additionally, the City has not remitted escheatable property to the State. In discussing this with City officials, the stated changes in personnel combined with the lack of written City policies and procedures regarding the monitoring and calculating of escheatment rules caused the City to fail to comply with the rules.

The Uniform Unclaimed Property Act (Public Act 29 of 1995) requires the Michigan Holder Transmittal Annual Report of Unclaimed Property be submitted annually by November 1.

Any holder of unclaimed property who fails to file a report of unclaimed property is subject to fines and penalties as prescribed in Public Act 29 of 1995.

#### ***Recommendation***

We recommend Management conducts an assessment and evaluation of unclaimed property held and file the required report within the annual required deadlines.

#### ***Views of Responsible Officials***

We have reviewed the finding and concur with the recommendation. The Finance Department's Treasury Division is currently in the process of conducting an assessment and evaluation of unclaimed property in accordance with the Unclaimed Property Act 29 of 1995, Escheat Law. Our assessment and evaluation includes a 60 days notification period prior to escheatment to the State of Michigan. Once due diligence is complete and the backlog of unclaimed property is either claimed or escheated, we will implement new procedures to conduct annual evaluations and submit the Michigan Holder Transmittal Annual Report of Unclaimed Property by November 1 of each year.



## **CITY OF DETROIT, MICHIGAN**

### **Schedule of Findings and Responses**

Year ended June 30, 2008

#### **Finding 2008-08 – Bond Ordinances**

The Water and Sewerage Disposal Fund revenue bond ordinances require amounts be set aside in a Bond and Interest Redemption Fund such that the aggregate balance is sufficient to provide for payment, when due, of the current principal and interest. During fiscal 2008, the City did not make the required transfers and, at June 30, 2008, the balance in the Bond and Interest Redemption Fund was not sufficient. The City transferred the amounts needed on July 1, 2008 and made the payments on a timely basis. Additionally, the revenue bond ordinances require (1) amounts be set aside in the Senior Lien Bond Account equal to the maximum annual debt service on all senior lien bonds outstanding, and (2) monthly deposits be set aside in an amount equal to one-twelfth of 3% of the budgeted operation and maintenance expense of each Fund for the fiscal year until the aggregate amount funded totals at least 15% of that year's budgeted operating and maintenance costs. The Sewerage Disposal Fund's Senior Lien Bond Account and its Extraordinary Repair and Replacement Reserve Fund were underfunded by approximately \$7.4 million and \$2.3 million, respectively, at June 30, 2008.

During the year, the City identified certain expenditures made by the Water and Sewerage Disposal Funds that potentially should not have been funded by bond proceeds. The City is currently unable to determine whether there were any legal violations or implications as to the tax-exempt nature of the bonds. The City does not believe the outcome of this matter will have a material impact on the financial statements.

#### ***Recommendation***

The City should identify all applicable material legal requirements contained in laws, regulations, grants, and contracts. Additionally, the City should implement procedures to monitor ongoing compliance with these requirements and take steps to ensure compliance on a continuous basis.

#### ***Views of Responsible Officials***

We have reviewed the finding and concur with the recommendation. With the new Treasury Cash Management System, which includes a debt management component, the City will better be able to comply with the legal requirements for its debt. Also, the City's Treasury Division has added a new cash manager that will be responsible for compliance with all debt requirements. The City will adopt the recommendation and implement procedures to monitor compliance with debt legal requirements on a continuous basis.

The Water and Sewage Disposal Funds Cash Management Section has implemented procedures to monitor and ensure that all required reserve balances and transfers are in compliance with the applicable bond ordinance. Also, the Funds are consulting with bond counsel to review expenditures related to its capital program to determine their impact, if any, on the tax status of related revenue bonds.